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More investment will mean more sustainable growth for Ukraine

ICPS economists have downgraded their forecast for economic growth for 2005 by 1 pp to 7%, given a longer-than-expected period of low investment inflows and a temporary decline in steel prices on global markets. In 2006, economic growth will slow down to 6% due to slower growth in consumer demand. The current Administration's victory in the 2006 Verkhovna Rada elections should make it possible for serious reforms to be launched in 2007. Better economic policy and an improving business environment should lead to brisker investment. As a result, real GDP growth will accelerate to 6.5% in 2007

Current situation

Over January–May 2005, Ukraine's economy continued to slow down. According to preliminary data, real GDP grew 4.7% over January–May 2005, less than 50% of GDP growth over the same period in 2004. Key reasons for slower growth were a slowdown in industry and dramatically lower growth in fixed investments: 4.5% in Q1'05 against 52.1% over the same period in 2004.

The review of previous privatization contracts, one of the core election promises of the new president, remains unresolved. The lack of a clear and agreed indication of the scale and principles of this process has put a damper on both domestic and foreign investment in Ukraine. ICPS economists argue that the Government needs to identify the terms and conditions underlying this process as soon as possible to enable investment to move into high gear and, thus, to ensure rapid and sustainable economic growth for the next few years.

In Q1'05, Ukraine registered high growth in consumer prices: the CPI grew 4.4% against December 2004. Prices grew because of large social outlays to Ukrainians and high inflationary expectations. Over April–May 2005, government price controls did manage to slow inflation down temporarily: over January–May 2005, the CPI rose 5.7%. However, such measures increased inflationary pressures whose consequences will be felt in H2'05.

In late April, the NBU slightly appreciated the hryvnia. As a result, the exchange rate has grown 5% since the beginning of 2005. For the first time since 2001, the real effective hryvnia exchange rate increased. In the opinion of ICPS economists, the interval and scale chosen by the NBU for this appreciation will not significantly hamper export capacities.

Slower economic growth among Ukraine's key trading partners is somewhat restricting opportunities for Ukraine's own economic growth through the external sector. An additional barrier to export-related growth potential is a temporary halt in the growth of world prices for steel, the result of excess reserves coupled with active output expansion by market players in recent years.

Forecast for 2005

ICPS economists have downgraded their forecast for real GDP growth for 2005 by 1 pp, to 7%. Key reasons for this slower growth in 2005 are:

- **Slower investment**. An uncertain situation around the review of previous privatizations coupled with frequent use of administrative pressure on business is preventing Ukraine's investment potential from being realized. A 6.7% decline in construction over January–May 2005 and a noticeable reduction in the number of press releases about business developments posted by major companies indicate that investment activity has abated. ICPS analysts expect that by Summer 2005, the Government will identify policy principles and measures to review key privatizations and other key investment issues, and that investment activity will accelerate in H2'05.
- **Stabilized situation on external markets**. The economies of Ukraine's key trading partners are slowing down. In addition, 2005 saw a temporary adjustment in steel prices on global markets, the result of large world reserves and expanding output during the period when prices were high. ICPS analysts expect steel prices to stabilize at the current level in H2'05.
- **Accelerating imports**. Imports are picking up faster than exports as the "Stop Smuggling" program kicks in and imports begin to move out of the shadow economy, and other steps, such as reduced import duty, a stronger hryvnia, simplified customs procedures, and more, have their effect.

Price controls applied by the Government in April–May 2005 helped hold back CPI growth, but they increased inflationary pressure. Given the greater-than-expected effectiveness of these steps, ICPS

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economists have adjusted their forecast for 2005 CPI growth downward by 2 pp, to 14%. To some extent, production costs will absorb slower consumer price growth and high inflationary expectations. The ICPS forecast for producer price growth for 2005 has been adjusted upward, to 15%.

After the hryvnia grew stronger in Spring 2005, upward pressure on it noticeably subsided. According to ICPS economists, the National Bank will support a stable nominal hryvnia exchange rate against the US dollar throughout 2005. Moreover, strengthening the hryvnia further might prove problematic because imports are growing faster than exports.

ICPS economists have upgraded their forecast for the growth of real disposable household income for 2005 from 15.5% to 18%, based on an upgrade in the forecast for real wage growth. However, the forecast for private consumption growth remains unchanged at 16% because of a trend towards growing wage arrears, especially in the public sector.

Forecast for 2006

ICPS expects real GDP to slow down to 6% in 2006. The key factor behind this slowdown will be slower growth in private consumption as increases in social payments taper off compared to 2005. ICPS economists do not anticipate a significant slowdown in investment prior to the 2006 VR elections because the results of these elections are fairly predictable and there are no expectations of significant change in the orientation of economic policy. Overall, investments will grow faster in 2006 than in 2005.

In 2006, economic growth among Ukraine's key trading partners will continue to slow down: ICPS expects growth among these countries to shrink from 4.4% in 2005 to 3.8% in 2006. Coupled with a drop in global steel prices, this will slightly limit export growth. ICPS economists forecast that export growth will slow down to 6% in 2006.

After the 2006 VR elections, the Government will shift the key emphasis in its economic policy from improving the current personal financial standing of Ukrainians to implementing large-scale, long-term reforms. The majority of these reforms will likely only be implemented starting in 2007.

Forecast for 2007

ICPS analysts expect economic growth to speed up to 6.5% in 2007. The key growth driver will be livelier investment because of: (1) a noticeable improvement in the business environment; (2) greater predictability in government policy and the economic situation; and (3) Ukraine's accession to the WTO. Foreign investment into Ukraine should reach US $2.5bn in 2007.

However, the impact of investment on Ukraine's economic growth in 2007 will be limited by the lack of capacity among domestic industries to meet investment demand. A major part of investment resources will have to be imported from other countries, which will push import growth to 16%.

2007 should be the year structural economic reforms kick in, according to ICPS analysts, and this will lead to high public spending—30% of GDP. However, because the economy will meanwhile be coming out of the shadow, the Budget deficit should not be higher than 1% of GDP in 2007.

In 2007, inflation will stabilize at a low level: consumer prices will grow 6%, while producer prices will rise 7%. Key factors behind this price stability will be: (1) stabilized growth in consumer demand; (2) a significant improvement in price regulating policy; and (3) stabilized prices on global markets.

Forecast risks

Key risks to the ICPS forecast for 2005–2007 are:

- the Administration's inability to develop and implement necessary reforms;
- reduced tax rates;
- sharp fluctuations on global commodity markets;
- the Government's inability to introduce market mechanisms for regulating prices;
- failure to accede to the WTO in 2006;
- a shift in the forex market to a more flexible exchange mechanism in 2005;
- a revision of GDP figures for 2004.

Key macroeconomic indicators

Years	2004	2005	2006	2007
Indicators	(est.)	(forecast)		
GDP, *billions UAH*	344.8	417.9	505.6	568.4
Real GDP, *apc*	12.1	7.0	6.0	6.5
Real industrial output, *apc*	12.5	9.5	8.0	8.0
Real agricultural output, *apc*	19.1	0.5	3.0	2.5
Real gross fixed investment, *apc*	10.2	7.0	8.0	10.0
Real total consumption, *apc*	13.1	13.1	7.6	7.6
Real disposable household income, *apc*	16.5	18.0	5.0	6.5
Consumer price index, *apc*	12.3	14.0	10.0	6.0
Net FDI, *millions USD*	1,711	1,800	2,000	2,500
Average monthly real wages, *apc*	23.8	15.0	8.0	10.0
Unemployment rate (ILO methodology), %	8.6	8.2	8.0	7.8
Exports of goods&services, *apc*	37.2	13.0	7.0	8.0
Imports of goods&services, *apc*	26.0	20.0	13.0	14.0
Current account balance, *% GDP*	10.5	6.7	3.3	0.4
Consolidated Budget balance, *% GDP*	-3.4	-3.0	-2.0	-1.0
Official exchange rate (average annual), *UAH/USD*	5.32	5.10	5.04	5.09

apc = annual percentage change

Sources: Derzhkomstat (State Statistics Committee), National Bank of Ukraine, Ministry of Finance; calculations and forecast by Quarterly Predictions

ICPS economists have been providing regular forecasts for the economic development of Ukraine since 1997. These forecasts are updated quarterly and published in ***quarterly predictions****. If you are interested in receiving this publication on a regular basis, you can subscribe today by contacting Andriy Starynskiy at (380-44) 484-4410 or by e-mail at marketing@icps.kiev.ua.*

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